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MONETARY AND FISCAL POLICIES WHAT THEY CAN AND CANNOT DO

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WHAT THEY CAN AND CANNOT DO

My purpose is to examine governmental financial policies as to their strengths and limitations. As a basis for such appraisal, it may be helpful to mention without discussion the objectives of monetary and fiscal policies, the tools available, and the agencies charged with responsibility over them. My background discussion will, therefore, merely recite objectives, tools, and responsible partners.

The objectives sought are two-fold:

(1) To foster orderly economic growth and sustain employment at the highest feasible level.

(2) To maintain the financial equilibrium of the economy, both internal, by protecting the purchasing power of the monetary unit, and external, by keeping international payments in balance. The last of these is currently of much concern to Britishers.

The tools used for general monetary controls (and I will not be discussing selective or direct controls such as those over stock market margins and consumer credit) are the well-known three: open market operations, rediscount rates, and reserve requirements. I have listed them in the order of their refinement, the first two having the delicate touch of the chisel; the last, the cruder power of the broad axe. The tools embraced by the term "fiscal policy" are debt management, taxation, and governmental expenditure.

In this country, those who carry the responsibility for the use or misuse of the monetary tools are the Federal Open Market Committee for open market operations; the Federal Reserve Bank directors, with review and determination by the Board of Governors, for rediscount rates; and the Board of

Governors of the Federal Reserve System for reserve requirements. These bodies all exist as a result of a delegation by the Congress of authority over money.

Debt management is the primary obligation of the U. S. Treasury, whereas changes in the form and rate of taxation are the ultimate responsibility of the Congress, as is the power to appropriate government funds. Although the executive branch initiates most changes in revenue and expenditure, and determines the rate at which appropriations will actually be used, Congress has the real responsibility as to the rates of taxing and spending by the Federal government. Of course, the amount of tax revenue actually collected moves up and down with the economic tides, and the latter also influence certain types of governmental spending such as crop supports and unemployment insurance.

Congress may also direct the use of Federal spending or of guarantees to stimulate particular portions of the economy. An example is the boost given to residential construction by encouraging the growth of mortgage credit, which has been mounting at a monthly rate of over $1 billion. So much for a recital of the governmental guns that may be trained on the two objectives, and those responsible for aiming and firing them.

How successful they will be in achieving economic growth and stability (the two objectives) turns upon the coordination and timing of their use by the team of partners who carry the several responsibilities, and by the psychological climate in which they are employed. My observations as to their strengths and weaknesses will be focussed, therefore, upon problems of coordination, timing, and group psychology.

Coordination in the use of credit and fiscal tools is complicated by conflicts inherent in the objectives sought. 1/ In Great Britain, brimful employment has been achieved, with job opportunities far exceeding the number of job seekers; but excessive domestic demand is diverting goods from exports as well as inflating imports, and wage and price increases, unless stopped in time, may well threaten the country's ability to compete in foreign markets. In consequence, the country is faced with serious difficulties in her efforts to keep her foreign accounts in balance.

The tools themselves need to be coordinated. A well-publicized example was the impact of the "pegging" of government bond prices, however needful to finance World War II, upon the functioning of monetary controls after the War had ended. In the language of former Chairman Eccles, it was a "built-in engine of inflation". Inflation continued, incidentally, despite large governmental surpluses. An example from abroad is Great Britain's reliance in 1955 upon monetary controls without adequate support from the budget. Despite two sharp increases in bank rate, despite moral suasion directed at banks to restrict advances, and despite the imposition of direct controls on consumer credit, inflationary pressures did not abate sufficiently to avoid further monetary and fiscal actions this year.

In Australia, after a lengthy period of frustrated attempts to combat inflation without coordinating fiscal and credit policies, combined action embodying important restrictions in both fields had to be taken recently. Further examples of the need for coordination are provided by the Scandinavian countries. In Sweden and Norway restrictive monetary policies have been adopted

1/ See article by Karl Bopp on "The Rediscovery of Monetary Policy--Some Problems of Application," in the Business Review of the Federal Reserve Bank of Philadelphia, August 1955.

to supplement fiscal restrictions in some sectors, and to offset the stimulation of continued governmental assistance in other sectors, such as housing. In Denmark, restrictive monetary policies proved insufficient until supplemented by restrictive fiscal policies.

Examples are not lacking, however, of coordination that has succeeded. In India, a planned budget deficit was offset by appropriate monetary policies. In Japan, inflationary developments were stopped in 1949-50 and again in 1954-55 by the combined application of both fiscal and monetary measures. The same result was accomplished in Austria in 1952. Of particular interest is the case of West Germany. The German "basic law" requires the Government to present a balanced budget. Nevertheless, the Finance Minister has accumulated large unspent funds, which are being kept idle on deposit with the central banking system. This circumstance has assisted the monetary authorities to avoid inflationary developments in the face of an unprecedented boom.

Our own country seems, in the absence of a shooting war, to be about to reap the benefits of fortunate support of monetary policy by fiscal policy. A Federal cash surplus in each of the fiscal years 1956 and 1957, if sizeable, would help to combat the inflationary impact of a prospective large expansion of industrial and other private investment. Moreover, a large number of Congressmen as well as administrative officials appear to view a boom period as one in which reductions in tax rates would be inappropriate.

But coordination is not easy. Take the problem posed for both the Treasury and the Federal Reserve at the time the discount rate was raised in November of last year. For some months, business confidence had been mounting. It was evidenced by the rise of industrial orders and of loans, by rising stock prices, by business plant expansion, by a scarcity of steel, cement, and glass, and by increasing prices of many important industrial materials and products. The discount action that such a situation might have indicated was delayed by the economic uncertainties stemming from President Eisenhower's illness in late September. That these uncertainties dissolved in the sober reflections of businessmen seemed to be indicated when the McGraw-Hill survey of capital additions forecast an overall increase of 1956 plans over 1955 of 13 per cent. The return of ebullience plus high seasonal demand for loans caused the Federal Reserve Banks, with the approval of the Board of Governors, to raise their rediscount rates in November even though the Treasury faced a refunding in December of over $12 billion. The Federal Reserve action, necessary as it was, made a more difficult problem for the Treasury in refinancing its maturing obligations in December. The action had to be taken at an unpropitious time despite some risk of unsettling the market for Government and private securities.

The "funding" of short-term debt tends to have anti-inflationary effect through reducing the liquidity of holders. Examples of its successful use are to be found in the United Kingdom (1951) and the Netherlands (since 1953). As already indicated, however, "funding" is frequently hampered by a reluctance to burden the Treasury with higher interest rates as seems to have been the case in Scandinavian countries before they ended their "cheap-money" policies in 1953-54. If "funding" cannot be employed at these times, then the other tools must be relied upon more heavily, as British authorities are discovering. Unfortunately, "funding" is most appropriate for the economy in times of inflationary danger when interest rates tend to be high, but to be most attractive to the fiscal authorities in times of deflation when interest rates tend to be low and the economic effect of the operation undesirable.

A problem illustrating one of the obstacles to coordination would appear to be in the making in Great Britain. The rigorous restraint now imposed by the Bank of England and by the Government would be strengthened, one would suppose, if governmental borrowing were on a long-term rather than a short-term basis. But a bank rate of 5-1/2 per cent discourages a long-term commitment to pay a high rate on borrowed funds and tempts the use of short-term borrowing in the hope that cheaper money may be available in later years. The debt managers, it must be recognized, are expected to pay attention to borrowing cost as well as to the best policy to pursue in terms of stabilization goals. This fact serves to underscore the essential complexity of the problem of attaining stable growth without inflation.

So far we have discussed coordination in terms of concerted action through maximizing the mutual assistance of monetary and fiscal policies. We turn now to another aspect of coordination: proper timing. Timing difficulties tend to hamper the effectiveness of fiscal measures as stabilizing tools more than that of monetary measures. Fiscal policies have a less direct and immediate influence than do monetary policies upon such causes of disequilibrium as inventory accumulation and the excessive use of mortgage or consumer credit. It is not that changes in fiscal policy are less potent; they are just less responsive and flexible. Fiscal decisions, since they are necessarily long in the making, may come at just the wrong time to improve business stability.

During recession, it is usually not difficult to have tax cuts enacted. It is more difficult to have tax increases enacted in times of boom. However, such measures have been passed in Belgium (1955), Denmark (1954-55), the Netherlands (1955), Norway (1955), Sweden (1955), and the United Kingdom (autumn 1955). The Netherlands has enacted a provision compelling corporations to prepay their taxes in order to reduce the excessive liquidity of the economy (1955). Tax changes for cyclical purposes have frequently taken the form of changes in tax-privileged investment allowances for business firms. Such allowances have been increased to combat recession, and decreased or abolished to combat boom conditions in the Netherlands, Scandinavian countries, and the United Kingdom.

The political difficulty of taking unpopular fiscal measures has led to the adoption of "built-in stabilizers" that would automatically offset inflationary or deflationary developments. However, these offsets are invariably incomplete even though they operate in the right direction. To cite a single example, a reduction of corporate profits in this country is offset only in part by a proportionate decline in the 52 per cent of profits that must be paid out as income taxes.

A further deterrent to the use of tax rate changes as cyclical remedies is the lag between the announcement of a new rate and its effect upon business decisions. Because of the practice of accruing taxes, rate changes that become effective at some time other than the start of a company's fiscal year may not exert their full impact upon executives' thinking as to price setting and expansion until they prepare the budget for the ensuing year. Not only do time lags detract from the effectiveness of fiscal measures, but they may cause a given measure to take effect at the very moment when the opposite type of measure is needed. For example, the Netherlands, in spite of efforts to adjust its fiscal policy to the cyclical situation, had large deficits in 1954 and 1955 when the country was experiencing an unprecedented boom. But in the far less prosperous year of 1952 the country did have a surplus.

Fiscal policy, however, tends to have a more direct effect than monetary policy on total disposable income, especially in the case of changes in taxes and public expenditures. It tends therefore to be subject to more pressure by special interest groups. Tax cuts have frequently been enacted and public expenditures increased at times when economic stability is threatened by inflationary pressures. Recent cases occurred in the United Kingdom, spring 1955; the Netherlands, 1954; Sweden, 1954; and Australia, 1954.

The structure of tax changes does contribute to growth. As a social objective, we seek a tax structure that is equitable and nonrepressive in its influence on normal economic incentives. Both corporate and individual taxes have a powerful impact upon the incentives to venture, to experiment, to expand, and to generate the economic forces so necessary to high employment and a rising scale of living. A recent example is the apparent stimulus to plant expansion afforded by provision for accelerated depreciation during and after World War II. The more we can contrive <u>forms</u> of taxation that enhance entrepreneurial incentives and diminish decentives, the more closely will financial authorities manage to achieve stabilization. But the tax structure problem is a separate one from the problem of whether a given fiscal policy is inflationary, neutral, or deflationary. The latter problem has mainly to do with the relationship of total tax revenues to total governmental expenditures.

Of the monetary tools, open market operations are responsive in the extreme. Buying and selling can be modified from day to day, and even from hour to hour, to adapt to fluctuations in the tightness of the money markets, and still work in the direction of economic stability. Open market operations, flowing from the instructions of the Open Market Committee, have the sensitivity of an automobile accelerator.

Discount operations are also responsive and sensitive, even though discount rate changes are only made from time to time to adjust to changes in levels of market rates. Discount rate changes signalize a recognition on the part of the Reserve System that a fundamental change has occurred in supply-demand conditions in the credit market. Open market and discount operations are closely related functionally--so closely related, in fact, that they are basically supplemental tools. Each affects the other and each reenforces the other.

For monetary authorities, the most fundamental problem of timing is to forecast changes in the business climate in order to take compensatory action before the figures actually prove its necessity. Promptness of action is imperative if the anticipated results are not to be reduced unduly by the time lag between changes in monetary policy and their effect on business activity If the authorities wait until the figures demonstrate beyond question that further credit restraint or stimulation is needed, the action may lose its effectiveness, in whole or in part. But the perils of action based on judgments in advance of confirmatory information are obvious!

A year or so ago a widely-read daily newspaper congratulated the Federal Reserve for taking appropriate monetary action six months in advance of the time that such action was obviously called for by economic facts. Much as we appreciate such kind words, we ought not to be credited with quite that much foresight. When we are that good, we are lucky, extremely lucky, rather than endowed with omniscience. Nevertheless, we do try as best we can to keep on top of the developing business and financial situation and to take action as quickly as possible.

Events of the Spring of 1953 serve to illustrate the powerful psychological forces that play upon business decisions and that must be taken into account if monetary and fiscal policies are to be useful. That Spring, ebullience was high, plant expansion was rapid, inventory accumulation was large, and credit demands were strong with prospects for large Treasury borrowing ahead. The monetary authorities countered by increasing restraint on bank credit expansion. Suddenly, in a matter of days, money became so tight as to endanger the smooth conduct of business, and the restraints were eased. In retrospect, it appears that the subsequent decline in activity is to be attributed largely to curtailment of governmental defense expenditures,--a curtailment that had not been scheduled when the monetary restraints were imposed.

The financial policy of 1907 that led to the founding of the Federal Reserve System six years later, the inventory panic with its crashing prices of 1920 and 1921, and the collapsing stock market of 1929 and 1930 all preach their respective sermons. One lesson of the depression of the 1930's would seem to be that if equity values suffer from too great destruction, those executives who should venture if the economy is to revive are too distraught and fearful to do so; or if they have the requisite courage and daring, they may no longer be considered credit-worthy by lenders.

On the other side is the psychology of ebullience and of unwarranted optimism. Financial history records boom after boom that burst because men "chased the fast buck" at the sacrifice of prudence. Two observations may be in order. One is that speculative fervor may not, the next time it injures the economy, take the form of stock market speculation like that of 1929 when margin requirements were low and the rewards of the call-money market were enticing. Speculation has many forms of dress and even of disguise. The second observation is that neither monetary control nor fiscal policy, nor the two in concert, can maintain economic stability if group psychology runs rampant. They cannot revive business from depression in the face of general despair; nor can they prevent inflation if business decisions lack the quality of prudence.

The apparent successes scored in recent years by the team of monetary policies, fiscal policies and business prudence are a cause of deep satisfaction to those who must worry about the future of our domestic and world economies. Though the record of failures in achieving sustainable economic growth coupled with stability is imbedded in the memories of those who suffered, the record of recent successes is such as to command attention and respect. Clearly the hope of the future lies in so managing ourselves and our affairs as to stress the coordination and timing of monetary and fiscal actions. Recent experience suggests that intelligence and moral fortitude can yield a better life, just as history records the tragic outcomes of man's failure to understand what is required and to act accordingly.